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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	
Price Cap Performance Review for Local Exchange Carriers	CC Docket No. 94-1
Access Charge Reform	CC Docket No. 96-262

OPPOSITION OF GTE

GTE SERVICE CORPORATION
and its affiliated domestic telephone
and interexchange companies

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SUMMARY

In its petition for reconsideration, Ad Hoc argues that the Commission erred by not giving weight to studies it submitted which, Ad Hoc asserts, would have produced an X-factor of more than nine percent if adopted. However, the Commission properly rejected the Ad Hoc studies as a basis for setting the X-factor, because: (1) its studies were based on proprietary software and neither the Commission nor interested parties could evaluate the methodology or documentation underlying its productivity estimate; (2) its input price index exhibits erratic fluctuations; and (3) the use of its proposed hedonic adjustment has not been justified. Consequently, the FCC should deny Ad Hoc's arguments for an increase in the X-factor for the same reason it rejected Ad Hoc's studies in the *Order* – they are unreliable and not supported by record evidence. Moreover, a proper evaluation of the record demonstrates that Ad Hoc's proposed X-factor of more than 9.0 percent cannot be sustained.

AT&T and Ad Hoc urge the Commission to reconsider its decision to rely on "total company" data, rather than interstate-only data, as the basis for measuring the LECs' productivity. The Commission has already rejected making such an artificial and arbitrary distinction, and they offer no new factual or theoretical support for adjusting the X-factor to account for any differences between interstate and total company productivity at this time. AT&T also requests that the Commission consider LEC revenues when selecting the X-factor. However, actual LEC revenues are irrelevant to a determination of the correct level of productivity.

AT&T further asks the FCC to reverse its decision to retain the low-end adjustment mechanism in the price cap system for LECs earning lower rates of return

or, alternatively, to reinstate the sharing obligations applicable to LECs whose earnings substantially exceed the rate-of-return levels prescribed by the Commission. Constitutional due process protections, however, require that the FCC retain the low-end adjustment factor. Moreover, because the purposes of the low-end adjustment mechanism and the sharing mechanism are unrelated, the Commission's decision to retain the low-end adjustment mechanism does not affect its decision to abolish the sharing mechanism. AT&T presented nothing in its petition to suggest that the Commission erred when it properly found that the benefits of removing sharing outweighed any possible benefits from retaining it.

Finally, AT&T claims that the *Order*'s retroactive application of the revised X-factor only to the PCIs for the 1996 tariff year should be extended to the 1995 tariff year as well. Grant of AT&T's request, however, would constitute unlawful retroactive ratemaking and would unfairly burden LECs subject to sharing. At a minimum, the FCC should not require retroactive application of the CPD because it cannot change LEC incentives for past behavior.

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OPPOSITION OF GTE

GTE Service Corporation ("GTE") and its affiliated domestic local exchange and interexchange telephone companies[1] hereby file their opposition to the petitions filed by the Ad Hoc Telecommunications Users Committee ("Ad Hoc") and AT&T Corp. ("AT&T") for reconsideration of the Commission's *Fourth Report and Order* in CC Docket No. 94-1 and *Second Report and Order* in CC Docket No. 96-262, released May 21, 1997, FCC 97-159 ("*Order*" or "*X-factor Order*").[2] GTE submits that the adjustments

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[1] GTE's affiliated domestic local exchange and interexchange telephone companies include: GTE Alaska Incorporated, GTE Arkansas Incorporated, GTE California Incorporated, GTE Florida Incorporated, GTE Hawaiian Telephone Company Incorporated, The Micronesian Telecommunications Corporation, GTE Midwest Incorporated, GTE North Incorporated, GTE Northwest Incorporated, GTE South Incorporated, GTE Southwest Incorporated, Contel of Minnesota, Inc., Contel of the South, Inc., and GTE Card Services Incorporated d/b/a GTE Long Distance.

[2] The summary of the *Order* was published in the Federal Register on June 11, 1997 (62 Fed. Reg. 31939). Notice of petitions for reconsideration of the *Order* was published in the Federal Register on August 1, 1997 (62 Fed. Reg. 41387).

sought by Ad Hoc and AT&T are unwarranted on the merits and would improperly exacerbate the already substantial and unlawful adverse impact of the new rules on price cap carriers like GTE.

I. INTRODUCTION

On May 8, 1997 the FCC amended its price cap rules to raise the productivity factor (the "X-factor") used to compute the price cap indices ("PCIs") for price cap carriers to an unprecedented high level. The FCC established a new X-factor of 6.0 percent, based on an arbitrary selection of data presented in the record, and continued adding a 0.5 percent Consumer Productivity Dividend ("CPD") with little explanation and no justification. The Commission also required that the new X-factor be applied retroactively, "as if" it were in effect during the 1996 annual access year, and declared that the sharing obligations incurred in 1996 would likewise remain in effect, notwithstanding its decision to end sharing for the future. All of these actions were arbitrary, capricious, unsupported by the record and otherwise unlawful, and GTE intends to address them in its pending appeal of that decision. GTE will discuss arguments related to these issues here only insofar as necessary to respond to the requests for reconsideration of the *Order* presented by Ad Hoc and AT&T.[3]

In its petition for reconsideration, Ad Hoc argues that the Commission erred by giving no weight to the two studies by Economics and Technology, Inc. ("ETI") that Ad

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[3] GTE believes it must respond to the petitions for reconsideration filed by Ad Hoc and AT&T to protect its interests in the event the FCC were to act on the petitions for reconsideration before the Court acts on GTE's petition for review.

Hoc submitted in this proceeding.[4] Specifically, Ad Hoc claims that the FCC's decision to reject its studies was predicated upon a misunderstanding of the nature and availability of the software that was used in their analysis. These alleged errors purportedly caused the Commission to reject substantial elements of the ETI Reports which, Ad Hoc asserts, would have produced an "X-factor" of more than nine percent.

AT&T petitions the Commission to reconsider its decision to rely on "total company" data, rather than interstate-only data, as the basis for measuring the LECs' productivity, arguing that the agency's methodology produces an understatement of nearly two to three percentage points in the X-factor. AT&T also asks the FCC to reverse its decision to retain the low-end adjustment mechanism in the price cap system for LECs earning lower rates of return or, alternatively, to reinstate the sharing obligations applicable to LECs whose earnings substantially exceed the rate-of-return levels prescribed by the Commission. Finally, AT&T claims that the *Order*'s retroactive application of the revised X-factor only to the PCIs for the 1996 tariff year (rather than for the 1995 tariff year as well) causes the current year's LEC access charges to be more than $360 million higher than they otherwise would be.

If adopted, the regulatory changes proposed by Ad Hoc and AT&T would cause further serious financial damage to GTE and its shareholders, would be antithetical to the aims of the price cap regulatory program, and would violate the FCC's duty to permit LECs a fair opportunity to earn a return on their regulated assets. Accordingly,

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[4] Ad Hoc Petition at 1.

for the reasons set out below, the Commission should deny the AT&T and Ad Hoc petitions.

II. THE FCC SHOULD REJECT PETITIONERS' REQUESTS TO INCREASE THE ALREADY EXCESSIVE X-FACTOR.

In its *Order*, the Commission made significant changes to its "interim" price cap plan and adopted a "permanent" price cap regulatory regime for ILECs. The baseline X-factor in the original and interim price cap plans was derived from the average of the short-term and long-term trends in rate reductions prior to its adoption of the original price cap plan in 1990, plus a CPD of 0.5 percent. In contrast, the Commission has now concluded that it should base its X-factor on a LEC total factor productivity ("TFP")-based measure of productivity and an input price differential. Also unlike the earlier plans, the new rules prescribe a single X-factor of 6.0 percent with a CPD of 0.5 percent and eliminate the option of choosing a lower X-factor coupled with sharing obligations.

Ad Hoc and AT&T contend that the 6.0 percent X-factor is too low for a variety of reasons. Ad Hoc argues that, notwithstanding erratic and impenetrable results, its own study, which produced a productivity target of more than 9.0 percent, was improperly ignored by the Commission. Moreover, it claims that an arbitrary "hedonic" adjustment is required to reflect accurately the impact of technological improvements in local exchange markets. AT&T and Ad Hoc also offer a further rationalization for increasing the X-factor, asserting that the Commission should somehow divine an interstate-only productivity factor despite the joint jurisdictional use of local exchange facilities. All of

these arguments have already been correctly rejected by the Commission, and the same results should obtain here.

A. The Commission Properly Rejected the Ad Hoc Studies As A Basis For Setting The X-Factor.

The FCC was fully justified in refusing to rely on the productivity studies submitted by Ad Hoc. The Commission gave no weight to Ad Hoc's X-factor estimates because, inter alia, Ad Hoc's ETI model exhibited erratic fluctuations in results, the documentation for its studies did not explain how it arrived at its productivity estimate, and it included an hedonic adjustment for which there was no support in the record.[5] Ad Hoc presents nothing in its petition that undermines the validity of this analysis.[6]

1. Ad Hoc's Studies Did Not Merit Consideration.

Ad Hoc argues that the Commission erred in rejecting Ad Hoc's productivity estimate on the grounds that "Ad Hoc submitted its models in the proprietary format of a commercial software program to which [the Commission did] not have access,"[7] because the software Ad Hoc used is publicly sold and distributed worldwide and is no more "proprietary" than other software.[8] Ad Hoc misunderstands the Commission's decision. The Commission rejected Ad Hoc's productivity estimate not only because it relied upon proprietary software, but also because the methodology and documentation

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5 *Order*, ¶ 38. An hedonic adjustment is designed to reflect that new equipment differs from the old in technology as well as in price. *Id.*, ¶ 66. Ad Hoc's further contention that the X-factor should be based solely on "interstate" productivity data is addressed below in the context of the AT&T petition.

6 *See* Ad Hoc Petition, Declaration of Patricia D. Kravtin, ¶¶ 4-27.

7 *Order*, ¶ 38.

8 *See* Ad Hoc Petition, Declaration of Patricia D. Kravtin, ¶¶ 7-13.

underlying Ad Hoc's productivity calculation was not available to the Commission or other parties.

In its *Fourth Further Notice*, the Commission cautioned that "[a]ny party submitting studies, proposed methods for calculating a X-factor or other empirical information must furnish promptly upon request by Commission staff or any party to this proceeding work papers and any other data necessary to replicate the results submitted in the proceeding. If any party fails to do so, we will accord no weight to those studies, methods, or empirical information in our deliberations."[9] Ad Hoc failed to explain fully how it arrived at its productivity estimate, including how it arrived at an hedonic adjustment of 10 percent. In fact, Ad Hoc apparently has still not provided that information, arguing in its petition for reconsideration that the software used to reach its estimate is commercially available rather than providing the missing information. Consequently, the Commission properly rejected its submissions.

The Commission also disregarded Ad Hoc's estimates because its input price index "exhibit[s] erratic fluctuations."[10] Ad Hoc now argues that the Commission erred because the fluctuations in Ad Hoc's input price index results reflect a consistent pattern of corrections to the data, and that the remaining fluctuations are a function of the underlying empirical data rather than the result of Ad Hoc's choice of methodology.[11] However, Ad Hoc's estimates of input prices were the most volatile

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9 *Fourth Further Notice of Proposed Rulemaking*, ¶ 15.

10 *Order*, ¶ 38.

11 *See* Ad Hoc Petition, Declaration of Patricia D. Kravtin, ¶¶ 14-18.

estimates presented by any party in this proceeding. This volatility was even more egregious in light of Ad Hoc's failure to make its estimates publicly available, because the causes for the volatility could not be fully investigated.[12]

Most importantly, however, acceptance of Ad Hoc's arguments here together with any consequent increase in the X-factor would compound the errors that currently infect the Commission's prescription. In establishing a 6.0 percent X-factor, the Commission overestimated productivity by: (1) using a fixed rather than a moving average mechanism for calculating the X-factor; (2) selectively ignoring years in which productivity figures were low; (3) rejecting USTA's entire study because of a single and, if necessary, correctable alleged weakness; and (4) using existing FCC-prescribed depreciation rates to compute the benchmark capital stock and implicit rental price components of capital stock valuation. The unreliability of Ad Hoc's proposed X-factor of more than 9.0 percent is starkly illustrated by a brief discussion of these factors.[13]

It should be self-evident that, in selecting a productivity estimate, the FCC should have relied on the LECs' most recent experience under price caps rather than others' self-serving data and arguments. For example, although the Commission concluded that a fixed rather than a moving average approach would be preferable for setting the X-factor, it never explained why normal fluctuations in the economy should not be taken

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[12] *Order*, ¶ 38

[13] Because GTE will be pursuing these issues in its pending appeal, it is not requesting that the Commission address them at this time.

into account, especially when such fluctuations have a clear impact on ILECs' ability to increase productivity.[14]

The FCC also never justified discarding productivity data that showed increases were lower than its preconceived estimates. In particular, the Commission disregarded both productivity figures from years it considered anomalous[15] and essentially the entire USTA productivity estimate.[16] Of course, such a systematic repudiation of all contrary evidence necessarily inflated the ultimate X-factor selected.

Similar distortions were caused by the FCC's use of its own prescribed depreciation rates in the X-factor calculation rather than rates that reflect economic market realities and by its failure to account for the dramatic marketplace changes promised by new access charge, universal service and local competition policies, particularly since the Commission will not review the X-factor for at least 3 years. It follows that the Commission made numerous errors in selecting an X-factor of 6.0 percent. Had the agency properly estimated achievable LEC productivity, it would have selected an X-factor well below 6.0 percent. In light of these errors, Ad Hoc's undocumented assertion that the X-factor should be set at over 9.0 percent is even more incredible. This is particularly true with respect to Ad Hoc's request for an hedonic adjustment.

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14 *Order*, ¶ 28.

15 *Id.*, ¶ 139.

16 *Id.*, ¶ 137.

2. An Hedonic Adjustment Has Not Been Justified.

Hedonic price adjustments are designed to reflect the fact that new equipment differs from old equipment in technology as well as in price. In its *Order*, the FCC correctly refused to apply an hedonic price adjustment to capital asset indices because such an adjustment would arbitrarily inflate the X-factor, stating that "neither Ad Hoc nor AT&T have shown that their hedonic adjustments accurately measure the effects of technological improvements."[17] Ad Hoc nonetheless argues that the Commission's finding is factually incorrect, because it failed fully to consider Ad Hoc's discussion of hedonic price adjustments in its submission in this proceeding and because a 10 percent annual hedonic adjustment is an allegedly conservative estimate.[18]

Ad Hoc's arguments miss the point. As the record reflects, the Commission rejected Ad Hoc's proposed adjustment on the ground that Ad Hoc failed to provide any evidentiary support for its proposition that an hedonic adjustment of 10 percent, or any other amount, would accurately measure the additional effects of technological improvements in the ILEC industry (apart from those already captured in the X-factor because they are included in the computation of the U.S. price indices) during the period of time the new X-factor will remain in effect. It would be arbitrary and capricious to adopt an hedonic adjustment based on general economic theory without any reliable showing that the proposed factor would accurately predict, based on verifiable factors, the effect of relevant technological improvements in this particular context.

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17 *Id.*, ¶ 67.

18 Ad Hoc Petition, Declaration of Patricia D. Kravtin, ¶¶ 24-26.

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In sum, the Commission should deny Ad Hoc's arguments for an increase in the X-factor for the same reason it rejected Ad Hoc's studies in the *Order* – they are unreliable and not supported by record evidence. Moreover, a proper evaluation of the record demonstrates that Ad Hoc's proposed X-factor of more than 9.0 percent cannot be sustained.

B. The FCC Was Correct To Reject Arguments That Productivity Estimates From Only Interstate Operations Be Used To Set The X-Factor.

The FCC declined to set the X-factor based on interstate-only data rather than total company data, finding that "the record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth."[19] In challenging this determination, AT&T merely repeated arguments that the Commission has already considered and correctly rejected on two occasions.[20] No grounds have been offered for revisiting this issue yet again.

In the *LEC Price Cap Performance Review*, the Commission declined to set the X-factor based on interstate only data rather than total company data, explaining that:

> No party has argued that the production functions (the technological relationship between input and outputs) significantly differ for intrastate and interstate services in ways that can be readily measured or separated. Indeed, intrastate and interstate services are largely provided over common facilities. We therefore tentatively concluded that TFP should be calculated on a total-company, rather

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19 *Order*, ¶ 110.

20 As noted above, Ad Hoc's proposed X-factor is likewise predicated on interstate productivity alone.

> than interstate basis. To the extent that parties can establish that inclusion of intrastate performance data introduces a systematic downward bias in TFP, we believe it preferable to address such a problem directly, rather than attempting to construct an interstate factor based on regulatory accounting and other regulatory requirements that may not fully reflect economic costs.[21]

The Commission also specifically rejected AT&T's argument that interstate productivity growth exceeds intrastate growth because the volume of interstate traffic overall is growing at a more rapid pace than is intrastate traffic.[22] It explained that, "[I]n light of the fact intrastate and interstate services share common facilities, the traffic growth differential alone does not establish that it is meaningful to distinguish two different measures of productivity."[23]

The Commission revisited this issue in its *Order*, concluding that "the record before us does not allow us to quantify the extent, if any, to which interstate productivity growth may differ significantly from total company productivity growth" and that no party had provided "a factual or theoretical explanation as to why its assumptions might be correct."[24] Accordingly, the Commission again found "no basis in the record for making an adjustment to the X-Factor to account for any differences between interstate and total company productivity."[25]

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21 *Price Cap Performance Review for Local Exchange Carriers,* First Report and Order, 10 FCC Rcd 8961, ¶ 159 (1995) (citations omitted).

22 *Id.*, ¶ 159 n. 309.

23 *Id.*

24 *Order*, ¶ 110.

25 *Id.*

AT&T has not offered any new factual or theoretical support for adjusting the X-factor to account for any differences between interstate and total company productivity at this time, nor can it. Interstate-only estimates simply are inconsistent with total factor productivity methodology and theory. A properly conceived productivity offset contemplates all of the disparate factors affecting the unit cost of production and measures changes in aggregate efficiency of production. Use of interstate-only measurements, which by design are restricted to particular inputs and outputs, would thus be contrary to the FCC's current views on the economics of price caps. Any attempt to apply arbitrary separation rules in order to create factors that consider only interstate data would be capricious. Further, unless both input and output measurements can be meaningfully separated into interstate and intrastate as opposed to only output, as in the AT&T study, there can be no valid interstate-only TFP. In fact, AT&T even admits that inputs cannot be separated and simply assumes that it is rational to split inputs evenly between the jurisdictions.[26] Accordingly, the FCC should deny AT&T's petition to reconsider the establishment of an interstate-only X-factor.

C. Actual LEC Revenues Are Irrelevant To A Determination Of The Correct Level Of Productivity.

AT&T suggests in its petition for reconsideration that the Commission should consider LEC revenues when selecting the X-factor.[27] However, the goal of price cap regulation – to create incentives for ILECs to improve productivity – requires the FCC to allow ILECs to retain revenues consistent with its rules. If ILECs cannot earn higher

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26 AT&T Petition at 9.

27 *See, e.g., Id.* at 3.

profits by increasing output or decreasing costs, there is no incentive for ILECs to increase productivity. The motivation to earn additional profits, as the Commission has previously found, is precisely what makes price cap regulation a good simulator of competition by encouraging efficient behavior and, thereby, serves the public interest.[28] Accordingly, reliable productivity measures, not earnings, should form the basis of the X-factor.

D. Constitutional Due Process Protections Require That The FCC Retain The Low-End Adjustment Factor.

The Commission retained the low-end adjustment mechanism in order to guard individual LECs against the revised X-factor producing "unreasonably low rates."[29] AT&T now asks the Commission to reconsider that decision.[30] It is indisputable, however, that the low-end adjustment factor must be maintained in order to ensure that the X-factor is constitutional. A utility subjected to rate regulation must be permitted a fair opportunity to earn a reasonable rate of return on its prudent investment.[31] Without a safety mechanism like the low-end adjustment factor, price cap regulation could violate the takings clause.

AT&T's alternative argument – that the Commission should reinstate sharing requirements if it retains the low-end adjustment mechanism – is equally specious.[32]

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28 *See Price Cap Second Report and Order*, 5 FCC Rcd at 6787.

29 *Order*, ¶¶ 11, 160.

30 AT&T Petition at 12-16.

31 See Federal Power Comm. v. Natural Gas Pipeline Co., 315 U.S. 575, 602 (1942).

32 AT&T Petition at 14-16.

The FCC properly found that the benefits of removing sharing outweighed any possible benefits from retaining it.[33] Further, the purposes behind the low-end adjustment mechanism and the sharing mechanism are not related. The low-end adjustment mechanism is designed to ensure that carriers are permitted a fair opportunity to earn a reasonable rate of return on their prudent investments.

In contrast, the sharing mechanism is designed to ensure that customers benefit, in the form of lower prices, from efficiency improvements ILECs achieve in response to price cap regulation. The Commission reasonably concluded that this purpose would be served by its aggressive X-factor prescription and the CPD. Because the purposes of the low-end adjustment and sharing mechanisms are unrelated, the Commission's decision to retain the former does not affect its decision to abolish the latter. Accordingly, the Commission should deny AT&T's petition for reconsideration.

III. GRANT OF AT&T'S REQUEST TO REINITIALIZE PRICE CAP INDICES FOR 1995 AS WELL AS 1996 IS ILL-ADVISED AND WOULD CONSTITUTE UNLAWFUL RETROACTIVE RATEMAKING.

In its *Order*, the Commission required "each price cap LEC to adjust its PCIs, effective July 1, 1997, to the levels for the 1997-1998 tariff year that would have been in effect had we adopted the 6.5 percent X-factor in time to become effective with the LECs' 1996 annual tariff filings."[34] In other words, the FCC retroactively applied the

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33 *See also Order*, Separate Statement of Commissioner Rachelle B. Chong ("Since sharing continues the inefficiencies of a rate-of-return era, I have long believed that a system of pure price caps without sharing would be preferable. I believe that we have correctly found today that sharing tends to blunt the efficiency incentives we sought to create through the price cap plan.") (footnote omitted).

34 *Id.*, ¶ 179.

new, higher X-factor to the 1996 PCIs. The Commission asserted that, because the X-factor it adopted in 1995 was "interim," carriers had reasonable notice that it would retroactively apply a higher X-factor, and that a similar retroactive adjustment was upheld by the court in *Bell Atlantic v FCC*.[35]

However, the Commission determined not to require reinitialization for the 1995 access year, properly concluding that reinitializing the 1995 access year PCIs would unreasonably harm LECs' efficiency incentives.[36] AT&T now asks the agency to reconsider that decision and expand its reinitialization requirement to include 1995 PCIs.[37] AT&T's petition should be denied both because it offers no arguments not previously considered by the FCC and because it would exacerbate the already unlawful adverse impact of the 1996 reinitialization.

A. Reinitialization of the 1995 Access Year PCIs Would Constitute Unlawful Retroactive Ratemaking.

The initial price cap indices were set based on rates established under rate base regulation. Each year since then, the indices have been increased by an inflation factor, decreased by an industry-wide efficiency factor, and adjusted for exogenous costs. As intended by price cap regulation, ILECs have had to find ways to become more efficient each year to maintain profitability. These efforts are cumulative, however, because each year's profits are built on the efficiency measures taken in the previous year, dating back to the origination of price cap regulation. By reinitializing the

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35 79 F.3d 1195 (D.C. Cir. 1996).

36 *Order*, ¶ 179.

37 AT&T Petition at 16-19.

1996 price cap indices today, the Commission has substantially undermined the legitimate business expectations of ILECs, enervated current and future shareholder confidence in ILEC businesses, and undermined the incentives for increased efficiency that price caps were intended to create. The Commission should not compound its error by retroactive application of the X-factor to the 1995 PCI levels as well.

In 1995, ILECs were given a choice between a 5.3 percent X-factor without sharing and a lower X-factor with sharing. Under the revised X-factor, those carriers that chose the lower X-factor with sharing could be required to forego more earnings than they would have foregone had they selected 5.3 percent without sharing, as happened to GTE in 1996. In effect, they would have to both factor an additional percentage reduction into all of their future PCIs and risk sharing obligations for their 1995 earnings, while non-sharing carriers need only do the former.[38] Because they cannot now avoid the increased risk, and any adverse consequences, from that 1995 choice, any reinitialization requirement would be unlawfully retroactive and may not, therefore, be applied as AT&T requests.

The Commission's characterization of the X-factor as "interim" does not cure this retroactivity problem. Had ILECs known in 1995 that choosing a lower X-factor with sharing would increase the risk that they would be disadvantaged in 1997 in comparison to choosing 5.3 percent without sharing, they likely would have chosen 5.3 percent without sharing. The interim label did not, and indeed could not, provide

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[38] The unlawfulness of this requirement as it applies to the reinitialization of 1996 PCIs will be addressed in GTE's pending appeal.

sufficient warning that the Commission would later engage in unlawful retroactive rulemaking by applying a new X-factor in this manner to previous years' indices.

The Commission's reliance on *Bell Atlantic v. FCC*[39] to validate its 1996 reinitialization requirement is misplaced in light of the Supreme Court's recent decision on retroactivity in *Hughes Aircraft Co. v. United States*.[40] In *Hughes*, the Supreme Court held that application of a 1986 amendment to the False Claims Act to conduct which occurred between 1982 and 1984 was unlawfully retroactive, because the defendants could not have changed their behavior in any way to avoid application of statutory provisions that did not exist at the time of their conduct. The similarity between the dilemma faced by the defendants in *Hughes* and the ILECs here is striking: The ILECs that chose a 4.0 percent X-factor with sharing in 1995 cannot now change their behavior in any way to avoid paying more in 1997 under the revised price cap plan than the ILECs that chose a 5.3 percent X-factor without sharing in 1995.

But, even if *Bell Atlantic* were still good law, the FCC's actions represent an unwarranted extension of the holding of that case. Unlike in *Bell Atlantic*, the Commission has now also changed the consequences of having chosen sharing in 1995. This violates the legitimate reliance interests of those carriers that elected an X-factor of 4.0 percent with sharing in 1995, which, as explained above, will be disproportionately harmed by the reinitialization than those carriers that elected an X-factor of 5.3 percent without sharing, in violation of the FCC's obligation to treat all

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[39] 79 F.3d 1195 (D.C. Cir. 1996).

[40] 117 S.Ct. 1871 (1997).

parties equivalently.[41] Under the doctrine established in *Melody Music, Inc. v. FCC.*, 345 F.2d 730 (D.C. Cir. 1965), the Commission must justify different treatment of similarly situated parties. The Commission cannot meet this burden here, particularly as the different treatment is the result of unlawful retroactive rulemaking.

B. At A Minimum, The FCC Should Not Require Retroactive Application of the CPD.

The CPD is intended to provide an incentive for price cap LECs to achieve even higher levels of productivity than reflected in their historical performance. However, it is self-evident that LEC incentives for increased productivity for 1995 cannot be changed now. Thus, reinitialization of 1995 PCIs using the CPD is simply irrational.

Moreover, the CPD and sharing serve the same purpose: they are designed to ensure that customers benefit, in the form of lower prices, from efficiency improvements ILECs achieve in response to price cap regulation. Because consumers will have already benefited from any sharing in the 1995 access year, there can be no further justification for also applying the CPD in addition to the new aggressive X-factor to those earnings even if the FCC were to require reinitialization of 1995 PCIs. In contrast, AT&T would receive a double benefit – both a refund of 1995 earnings and artificially lower rates as a result of reinitialization using the CPD. Moreover, absent another "deal" between AT&T and the FCC, consumers would likely see nothing additional. Accordingly, the Commission should at a minimum deny AT&T's request to apply the CPD retroactively to 1995.

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[41] *See Bell Atlantic*, 79 F.3d at 1205, 1207.

IV. CONCLUSION

For all of the foregoing reasons, as well as those set out by the Commission in the *X-Factor Order*, the petitions for reconsideration filed by AT&T and Ad Hoc should be denied.

Respectfully submitted,

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August 18, 1997

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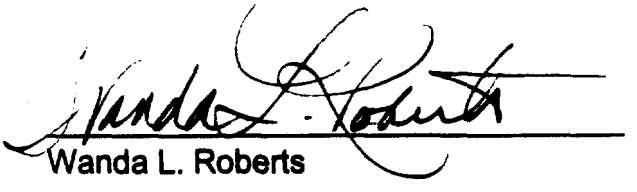

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